BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF MISSOURI

In the Matter of Union Electric Company d/b/a AmerenUE for Authority to File Tariffs Increasing Rates for Electric Service Provided to Customers In the Company's Missouri Service Area.	))))	**Case No. ER-2007-0002** Tariff No. YE-2007-0007

AARP's Prehearing Brief

COMES NOW AARP, by and through counsel, and pursuant to the Public Service Commission's (Commission's) September 12, 2006 Order Adopting Procedural Schedule, hereby submits its Prehearing Brief.

Just and reasonable electric rates are essential to AARP's over 755,000 members in Missouri. Access to affordable electricity service for air conditioning in the summer and heat during the winter is absolutely necessary for many of older consumers. Despite the fact that two thorough, independent rate case audits show the need for a significant revenue requirement *decrease*, Union Electric Company d/b/a AmerenUE (AmerenUE) continues to pursue a 10% electric rate increase for residential electric consumers. Some industrial parties are recommending even higher percentage increases for the residential class. Moreover, AmerenUE is proposing a Fuel Adjustment Clause (FAC), a mechanism that is unfair to consumers, and ill-suited to AmerenUE in particular.

AARP supports the December 29, 2006 Overearnings Complaint, filed by the Staff of the Commission (Staff) in this case, calling for an overall rate reduction based on the overwhelming competent and substantial revenue requirement testimony filed thus far in this case. This prehearing brief, however, focuses primarily on rate design testimony, summarizing the issues that are important to setting rates that are just and reasonable from the perspective of residential consumers.

I. Fuel Adjustment Clause

A. Approval of AmerenUE's proposed FAC would be unlawful.

As AARP has previously pointed out in its October 9, 2006 Motion to Reject Fuel Adjustment Clause Tariff, AmerenUE's FAC proposal was filed subsequent to the tariff filings that were suspended to initiate this rate case, and thus is procedurally out of time. AmerenUE's FAC proposal may not be lawfully considered by the Commission, and approval of such would constitute reversible error. Allowing AmerenUE to initiate a new rate request in a separate filing after it has already initiated a "file and suspend" tariff proposal violates the requirements of Subsection 386.266.4 RSMo Supp. 2006. A general rate case proceeding that has already been initiated by a tariff filing may not have its scope further enlarged after the suspension period has begun. AmerenUE's initial tariff filing (which includes no tariff proposal regarding a FAC or other RAM mechanism) served to place the public on notice as to the scope of this proceeding, and it may not subsequently expand upon its rate request. Allowing AmerenUE to file yet

another rate increase request in the middle of this rate case proceeding constitutes an unlawful "pancaking" of rate increase requests, one on top of another.

B. The proposed FAC is unreasonable because it is generally unfair to consumers.

Notwithstanding the legal issues mentioned above, there are several reasons why cost adjustment mechanisms for regulated monopoly electric companies are not recommended. While there are valid arguments for and against their use, the balance of policy arguments weighs against cost adjustment mechanisms in most cases. Binz/Brockway Direct, Exhibit 750, pp. 11-14.

First, a cost adjustment mechanism tends to dull the incentives to efficiency that cost of service regulation provides to utilities. To see why, the Commission should consider that a firm operating in a competitive market is not able to change prices to accommodate changes in costs, at least not unilaterally – not until the market price changes. Pressure from cost increases requires a competitive firm to become more productive in order to maintain its profitability. Id., p. 11. It has long been recognized that "regulatory lag" in cost of service regulation mimics this process in a competitive market. It can benefit customers and the utility alike by supplying the incentives that competition provides in other industries.

The most important thing to remember when considering whether to adopt a cost adjustment mechanism is that moving away from traditional regulatory treatment comes with a potentially large cost. Id., p. 12. Cost adjustment mechanisms are often

adopted by regulators not because of the incentives they provide, but in spite of them. Id., p. 12.

The second argument against cost adjustment mechanisms is that they tend to skew choices the regulated company must make by rearranging its economic incentives. A utility is continuously faced with short-term and long-term decisions about fuel and power purchases, whether to "build or buy," etc. To the extent that an adjustment mechanism is a "thumb on the scale" for some choices in preference to others, it may induce an electric company to make choices it might not otherwise make, to the detriment of its customers. Id., pp 12-13.

Despite AmerenUE's assurances that the Commission should rely solely on prudence reviews to provide incentives, regulatory experience has shown that after-the-fact prudence reviews are a crude and considerably-less-than-perfect way to catch inefficiency. Brockway Surrebuttal, Exhibit 751, p. 8-9. First, the standard for finding imprudence is in practice, if not in law, higher than the standard for identifying inefficiency. Second, costly after-the-fact reviews of a management's activities are no substitute for before-the-fact alignment of management motives and consumer interests. Id., p. 9.

The third argument against the use of cost adjustment mechanisms relates to their fairness. Cost adjustment mechanisms shift the balance of risk between utilities and their customers; more generally, they change the balance of equities embodied in cost of service regulation. Exhibit 750, p.13. It would be a rare utility that would propose a cost mechanism to track decreasing costs. Id., p. 13. By removing an

upward-trending cost and tracking it with a cost adjustment mechanism, the balance of fairness in ratemaking is changed. Id., p. 13.

It is a common misconception that utility regulation is a "cost-plus" exercise and that a regulator's duty is to ensure that companies "recover" their costs. This is factually incorrect. Id., p. 17. Under cost of service regulation, past costs are not "recovered;" they are simply used as a guide to the future costs that new rates attempt to match. In fact, "recovering" past costs, absent a specific exception, is retroactive ratemaking. Id., p. 17. An FAC distorts the traditional ratemaking equation and essentially inoculates a future rate request of a utility from a claim of retroactive ratemaking with respect to the subject costs. Id., p. 18. *Adjustment clauses such as the FAC significantly reduce the pressure on a utility to be efficient, in its fuel and purchased power operations, but more generally in all its operations. Simply put, the "cure" offered by an FAC can be worse than the "disease".* Id., p. 23.

C. The FAC is particularly ill-suited for use by AmerenUE.

An FAC should only apply to an electric company that has fuel costs which fluctuate significantly and which are also outside the utility's control. Id., p. 14. AmerenUE has not offered any evidence in support of the FAC proposal that shows the Company's power costs are expected to change rapidly in Missouri. While it has shown some evidence that fuel costs may increase over time, this does not necessarily indicate that the Commission should institute a "recovery mechanism." To the extent that increases in cost cannot be offset by productivity gains, increased sales, etc., the

utility always has the alternative to request an increase in rates. This type of pressure on a utility to become progressively more efficient is actually a *good thing*: good for customers and companies alike. Id., pp. 14-15.

An FAC is also unreasonable for a utility like AmerenUE which has significant ability to control variations in fuel and purchased power costs in the short term and in the long term. Here is a partial list of drivers for fuel and purchased power over which AmerenUE exercises control or significant influence:

- Basic choices in the utility's resource plan
- The ratio of owned generation and purchased power
- Terms of wholesale contracts
- Efficiency of system operations
- Transmission system design and operation
- Degree and type of fuel risk in purchase decisions
- Hedging activities
- Demand side choices
- Advocacy for beneficial rate design proposals

Id., p. 15.

AmerenUE is neither passive nor powerless in the face of changing fuel and power costs. The Company shapes its power cost future by the numerous choices it makes in these areas. The Commission should tread carefully when changing the way it regulates these activities and the basic incentives provided to AmerenUE. Exhibit 751, p. 8. To the extent the fuel adjustment clause moves the risk of substandard performance in these areas effectively to the customer, away from the utility (i.e. further down the line from 0% reconciliation of fuel costs and rates to 100%, as would be the case in the company's proposed FAC), the company has fewer incentives to manage its

operations and planning in a fuel-prudent way. Id., p. 8. AARP opposes the adoption of any FAC for AmerenUE because of the damage that it will do to resource planning decision-making.

The presence of regulation in a market shapes the behavior of the market participants. While utility regulators might want to limit their role to being a substitute for the competition that is missing in these industries, it is rarely possible to limit regulation's effects that way. Exhibit 750, p. 16. AmerenUE has operated in Missouri without a power cost adjustment mechanism since 1979. This has created a desirable risk/reward proposition for consumers *and* for the Company. Id., p. 16.

Under the current regulatory regime for AmerenUE, fundamental decisions such as whether to "build or buy," whether and how to hedge power costs, choices of fuel acquisition strategies, and even rate design choices are shaped by the fact that differences between projected and actual power costs accrue to the benefit or detriment of shareholders between rate cases. Id., p. 16. A FAC mechanism alters in a fundamental way the risk analysis that AmerenUE executive will consider when making those decisions. Id., p. 16-17.

AARP opposes AmerenUE's "margin-sharing proposal" for treating off system sales within a FAC (the "SMS" factor) as unfair. Id., p. 19-23. It is interesting, however, that on this particular piece of its proposal, AmerenUE is arguing for a sharing structure that would purportedly maintain incentives for efficiency. The exact same arguments can be made to argue against the FAC proposal itself, because it would simply track expense levels without any sharing. Id., p. 23.

The pre-filed testimonies of Staff witness Warren Wood, State of Missouri witness Michael Brosch, and Public Counsel witness Ryan Kind each make additional compelling arguments that a FAC is an unreasonable option for treating fuel and purchased power costs *for this particular electric utility*. These arguments should be considered seriously, especially in light of the FAC's many anti-consumer elements. The new law (SB 179) contemplates that the Commission may reject any FAC proposal when it does not fit a particular company's situation. AmerenUE is clearly an electric utility that neither needs nor deserves a FAC.

D. <u>If the Commission chooses to consider a FAC, despite all consumer objections to the contrary, modifications should be added to mitigate the identified harms of such a mechanism.</u>

Current regulation incorporates an estimate of fuel and purchased power costs in base rates. If actual costs are lower, the utility earns more money; if actual costs are higher than the base rate increment, the utility earns less. None of the variation from the base is added to or subtracted from base rates. Thus, current regulation is the ***0% Pass-Through Case***, retaining a strong incentive for AmerenUE to act prudently. Exhibit 750, p. 25. In contrast, the FAC proposed by AmerenUE would track every penny of differences between base rates and actual power costs. Whether over or under, the entire variation and risk would be passed through to customers in the form of an increment on the monthly bill. The AmerenUE proposal is the ***100% Pass-Through Case***. Exhibit 750, p. 25.

Between these extremes are infinitely many middle-ground cases. If the Commission chooses to adopt some version of an FAC for this utility, against all of the serious objections raised, it is perfectly reasonable for the Commission to apply the FAC to 50% of the over/under deviation from base rates. Id., p. 25. If the Commission approves a ***50% Pass-Through FAC***, the vast majority of AmerenUE's power costs will still be collected in base rates. It is important to understand that the 50% fraction applies only to the variation from that base amount. And since the fraction applies symmetrically to cost differences, the utility will sometimes over recover, sometimes under recover, at half the rate that happens today. Id., p. 25.

By using the 50% rule, the Commission would strike an exact middle ground between the type of regulation that has existed since 1979 in Missouri and the type of regulation proposed by AmerenUE in this case. Id., p. 26. This is what the Missouri Legislature had in mind when it granted the Commission the ability to "approve, *modify* or reject" any FAC proposal. Subsection 386.266.4 RSMo Supp. 2006. (emphasis added). This 50% approach would retain the same incentives for efficiency that traditional cost of service regulation provides to utilities. When faced with the choice of acting to lower its expenses, AmerenUE would know that it will be allowed to "keep" half of the costs savings in this approach. In contrast, under the 100% FAC proposed by the Company, any efficiency gains are taken away from AmerenUE at its next FAC filing. Id., p. 26.

The same logic applies in reverse. Unless a utility's bad behavior is found to be imprudent (a very high standard) it faces no consequence for incurring excess costs under the FAC. Excess costs will simply be passed through in the next FAC filing. Id.,

p. 26. On the other hand, if the utility is sharing its over/under power cost results, the utility faces a disincentive for bad behavior that results in higher costs because only half of such higher costs are passed through the FAC, with the balance absorbed by the Company. Id., p. 26.

There are other examples of fuel adjustment mechanisms in other states that are more sophisticated than AmerenUE's proposal, such as the Wyoming tariff of Rocky Mountain Power, approved by the Wyoming PSC in May 2006. See Exhibit 750, pp. 27-31; Attachment RJB-7. Given the weak incentive that prudence reviews provide, the Commission should retain some of the strong incentive that current regulation provides, in any FAC that is adopted.

II. Class Cost of Service / Rate Design

In its class cost of service study (CCOS), AmerenUE allocates its production demand costs to customer classes on the basis of a commonly used factor called the Average and Excess Demand (AED) Factor. In general terms, generation costs are allocated to the customer classes based on a factor derived from of each class's average level of demand throughout the year and the class's (non-coincident) peak demand during the year. Exhibit 750, pp. 33. AmerenUE's proposal, which calculates each class's non-coincident peak demand using the four highest monthly peak demands is not the best method. Id, p. 33. While the non-coincident AED method continues to be used in some state jurisdictions, its use appears to be declining. Id, p. 33. The major shortcoming of this method is its reliance on the non-coincident peak demands of the customer classes, whether or not the peak coincides with the system

peak. Id, p. 33. To fairly apportion the costs of peak demand, it is obviously preferable to consider the demand of each class at the time of the system peak (the coincident demand). Id, p. 33.

There are other widely-used cost allocation methods that incorporate more directly the class coincident peak demands to allocate demand costs. One such method is the Peak and Average Method discussed in the NARUC Cost Allocation Manual. This method develops allocation factors that appropriately combine the coincident peak demand of each class with each class's average demand (its energy use). Id, pp. 33-34. There are also more sophisticated methods for allocating costs, such as methods that measure the contribution of each customer class to the total system demand in each hour of the year. Such methods would produce fairer results than the 4-NCP AED used by AmerenUE. Id, p. 34.

AmerenUE's class cost of service study is also flawed in that it uses the "zero-intercept method". The term "zero-intercept" comes from the fact that the relationship between distribution system costs, system sales, and the number of customers is analyzed using multivariate regression analysis. Id., p. 34. The value where the curve of the equation crosses the y-axis is the hypothetical distribution cost for a system with zero usage. If the cost does not vary with usage, so goes the argument, it must vary with the number of customers. Id., p. 35. This method is closely related to the "minimum system" concept that is sometimes advocated by utilities as a justification of higher customer charges. Each method (zero-intercept and minimum system) attempts to prove that a fraction of the distribution system is properly classified as a "customer-

related" cost. Id., p. 35. There are several shortcomings of this method, and several errors in the logic that undergirds the theory:

- The theory is based on a fictional or hypothetical distribution system;
- The costs are not truly customer-related costs;
- The theory does not account for differences in density of customers;
- The methods shift costs between customer classes in unacceptable fashion and produces a too-high customer charge.

Id., p. 35.

Regulatory expert Dr. James C. Bonright, the "academic dean of public utility regulation", has exposed the flaws of the "zero intercept" or "minimum system" method:

> … [the cost of a "minimum system"] should be recognized as a strictly unallocable portion of total costs. And this is the disposition that it would probably receive in an estimate of long-run marginal costs. But fully distributed cost analysts dare not avail themselves of this solution, since they are the prisoners of their own assumption that "the sum of the parts equals the whole". They are therefore under impelling pressure to fudge their cost apportionments by using the category of customer costs as a dumping ground for costs that they cannot plausibly impute to any of their other cost categories.
>
> Bonbright, Principles of Public Utility Rates, 1961 pp. 348-349. (Emphasis added.); See Attachment RJB-8 to Exhibit 750 for a large discussion by Dr. Bonbright.

There are real life examples of the flawed logic of this approach as well. If one were to analyze the cost "caused" by a visitor to one's business, what would it mean to calculate the customer-related costs of a grocery store or automobile dealership? A grocery store does not seek to collect from each customer the per-customer cost of a parking lot or the capital cost of a store's lighting fixtures even though those costs are

"capacity costs" that are unrelated to the amount of product that customers purchase. Similarly, while these costs will ultimately vary with the number of customers who use the store (more customers mean more parking spaces and more lighted floor space) the grocery store does not attempt to assess a minimum-grocery charge to each customer. Id., p. 36.

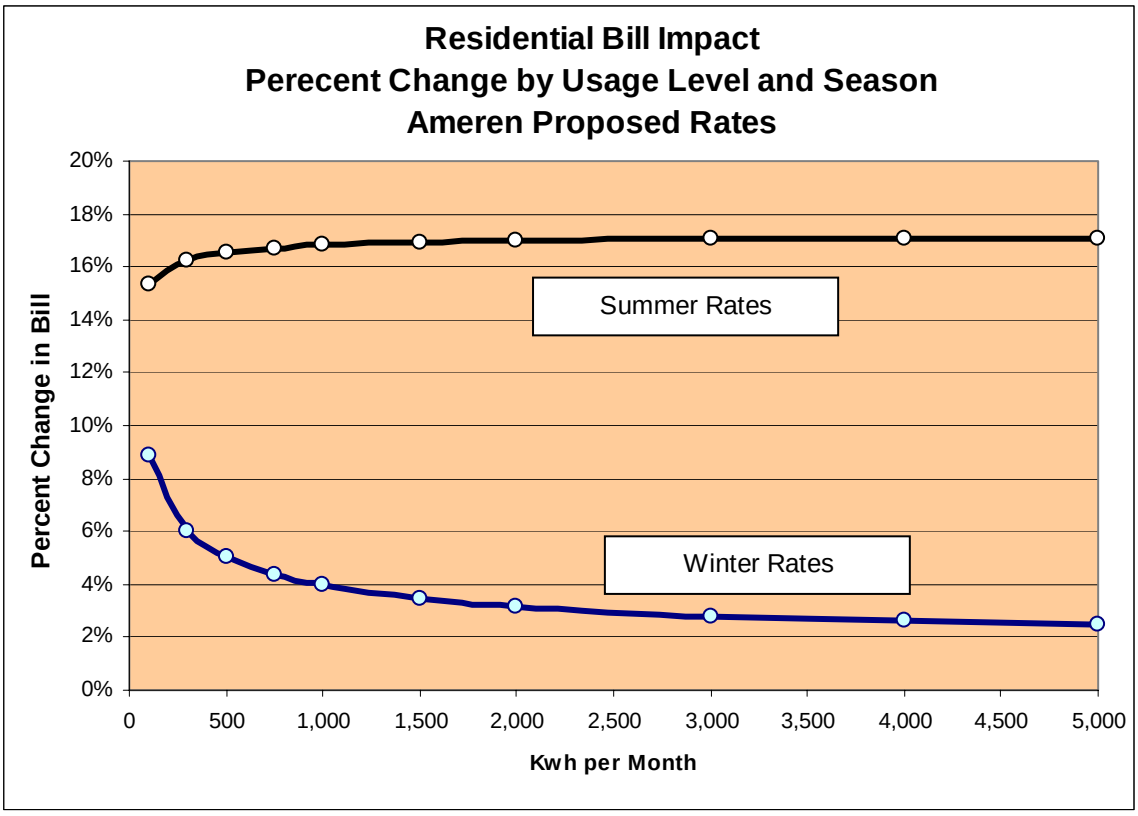
There are two unfair results of using the zero intercept method. First, the method shifts the Company's revenue requirement away from large distribution customers such as Large General Service and Primary General Service and toward the Residential customer class. The reason is easy to see: some fraction of distribution costs is being allocated on per-customer basis. In this circumstance, an individual residential customer is allocated the same cost as a large commercial customer using hundreds of times more electricity. Id., p. 38.

The second impact of the zero-intercept method is that it results in a higher monthly service charge for residential customers. Since the method classifies relatively more costs as "customer-related" (even though these costs are for poles, transformers and overhead lines), it drives up the pool of dollars to be collected in the customer charge. Id., p. 38. It is important to understand that this effect is separate and independent of the class revenue-shifting effect discussed above. For all of the foregoing reasons, the Commission should not set the monthly customer charge based on a mathematical abstraction like the "zero-intercept" of a regression equation.

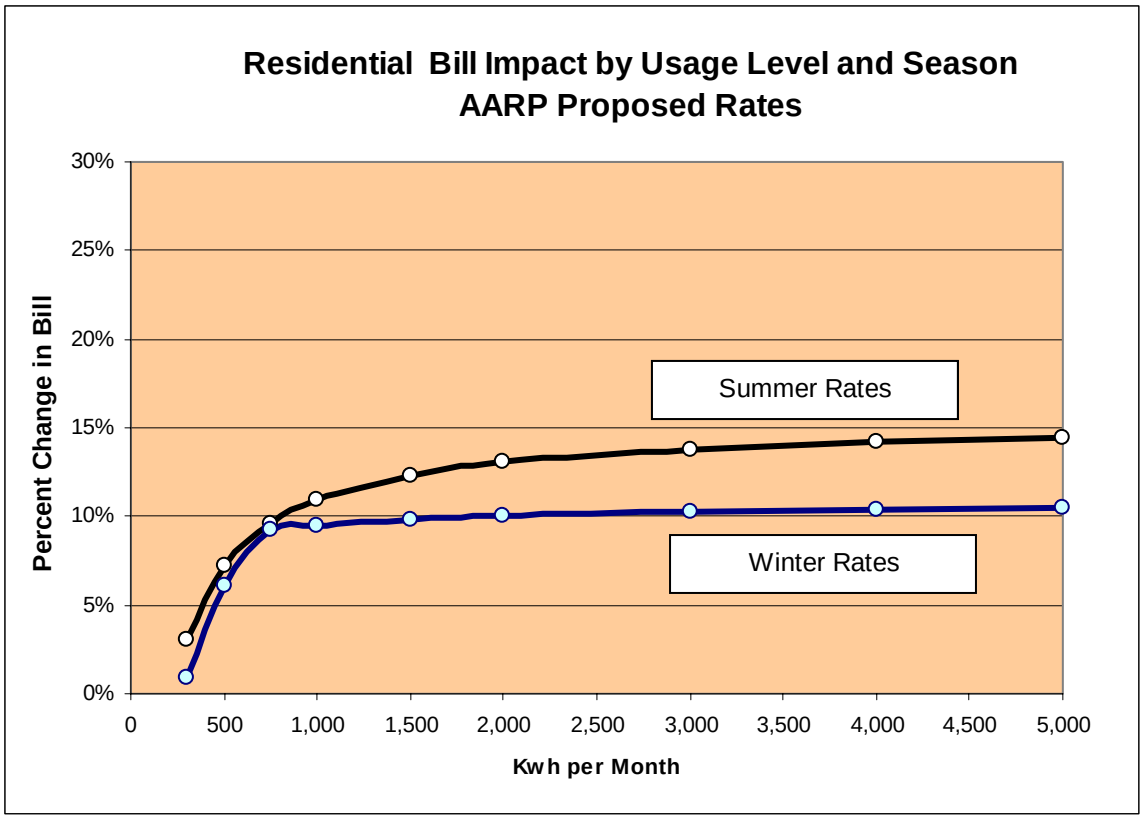
AARP proposes an additional change to the cost of service study performed by AmerenUE, related to the winter/summer differential. In order to design separate rates

for the summer season (June-September) and the winter season (October-May), AmerenUE proposes to collect 60% of the demand costs during the four summer season months and 40% of the demand costs in the eight winter season months. Exhibit 750, p. 42. The decision to collect 60% of demand costs in four months has the expected effect on rates: summer residential rates are much higher than winter rates. This may have a plausible cost-based rationale. However, the differential between summer prices and winter prices is becoming quite large as this method is applied year after year. Id., p. 42.

Under the rates proposed by AmerenUE, the average residential summer kWh would cost 9.64 cents, while an average kWh in the winter would cost 5.64 cents, a ratio of 1.7 to 1. Id., p. 43. A related effect is that the Company's rate design raises summer rates by about 16%, while winter rates are raised by only about 2.8%. Id., p. 43. The following chart, from Attachment RJB-6 to Exhibit 750, shows how the impact of the Company's choice of 60% loads the increase on summer rates:



AARP proposes that the fraction of demand costs recovered in the summer be reduced to 55% from 60%. Id., p. 44. This has the effect of reducing the ratio of summer and winter prices. Under AARP's proposal, any rate increase would be spread more evenly between summer and winter rates. The following chart, also from Attachment RJB-6 to Exhibit 750, also shows that the AARP-recommended rates have a smaller and more moderate impact on smaller-use customers:



AARP performed its own class cost of service study which modifies AmerenUE's to reflect three changes that correct the problems previously discussed:

- Using the 4-CP Peak and Average Method to allocate production demand costs;
- Classifying accounts 364 through 368 as demand-related and allocating these costs using the Company's distribution demand allocators;
- For the residential customer class, recovering 55% of annual demand costs in the summer season, compared to 60% in AmerenUE's CCOS study.

Exhibit 750, pp. 39-42. The results of AARP's CCOS study may be found on Attachments RJB-1 and RJB-2 to Exhibit 750.

A rate design based on AARP's study will more fair allocate costs and its proposed rate design will result in more reasonable rates than the other rate design proposals in this case, especially when the overall equities between large and small customers in taken fully into consideration.

WHEREFORE, AARP respectfully requests that the Commission order a rate reduction to reflect the AmerenUE's current over-earnings, to reject AmerenUE's proposed FAC, and to adopt a rate design that is consistent with AARP's cost of service study.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that copies of the foregoing have been emailed to counsel for each of the parties on the service list for this matter on this 6th day of March 2007.

/s/ John B. Coffman